

# Corporate Cash Alert

*Follow the Market, Not the Fed*

February 28, 2023

# Introduction

In recent client meetings, there have been questions regarding our decision to extend maturities. The key counterarguments appear solid at first glance: higher yields are expected with the Fed still tightening, and currently, money market funds are offering returns that are similar to those on longer-dated bonds.

This Alert expands on our rationale, which is based on a fundamental point: markets are forward-looking and lead the Fed. History shows that at certain points in the cycle, short-term markets look past the tightening phase and focus on the follow-on impacts. Current conditions are reminiscent of turning points in previous cycles that signaled lower rates were in the offing. Below we present our recommendations on how to position portfolios. These vary based on Investment Policy (IP) constraints, cash-flow profiles, and investment horizons. For certain mandates, it's time to extend; for others, continued patience is key.

## Reading the Tea Leaves

At the critical turning points of any given cycle, a consistent pattern tends to emerge where *market developments lead the Fed*, not the other way around:

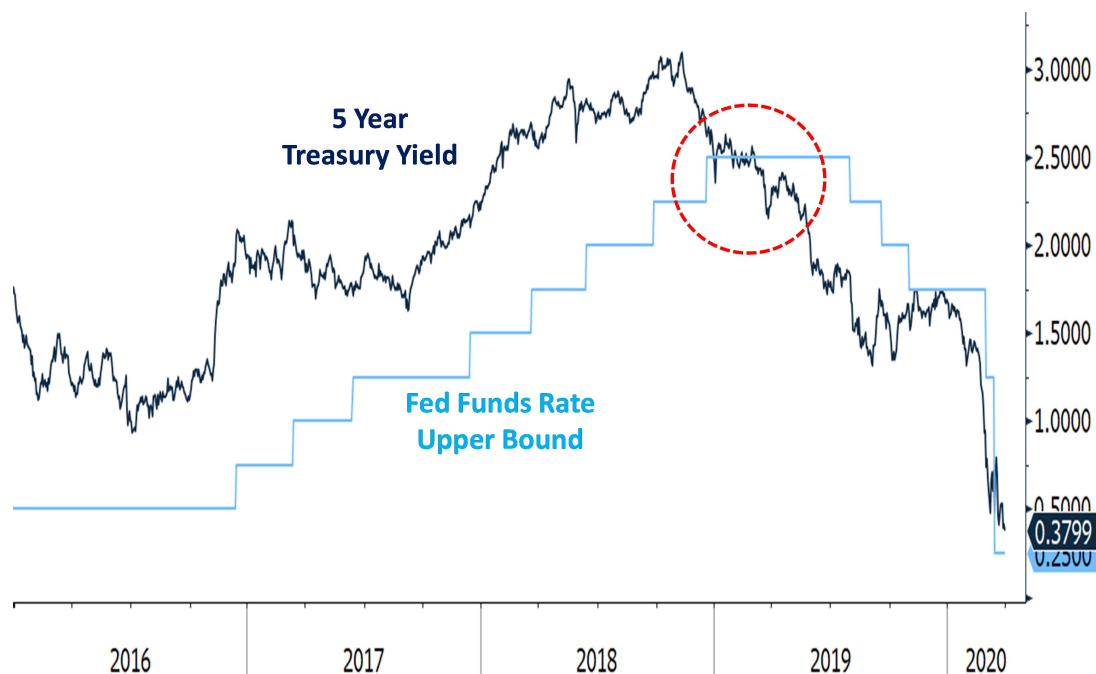
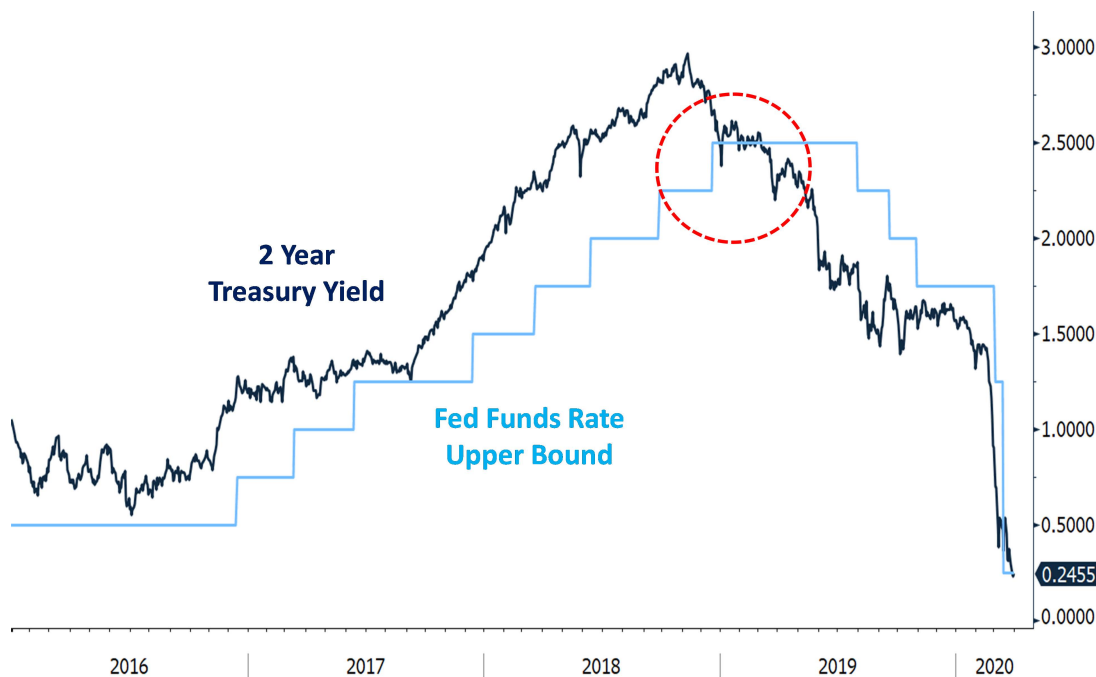
- When investors think we've reached the cyclical trough in the Fed Funds rate, they begin to think ahead to when a stronger economy will bear higher rates. Market yields begin rising to reflect higher odds of liftoff, well before the first Fed hike occurs.
- Conversely, once markets perceive the peak in Fed Funds is drawing near, investors begin placing much greater weight on the expected consequences of elevated policy rates (i.e., a slowing economy). Yields start moving lower ahead of the first Fed cut, anticipating the need for a fresh easing cycle.

As we wrote last month: "...rates typically move in advance of the Fed, both up and down, reacting to the implication of the data that will ultimately drive the Fed's future actions. At this advanced point in the hiking cycle (where many investors think we're close to reaching the apex), each additional tightening in the Fed Funds rate is no longer automatically accompanied by a lockstep increase in market interest rates." (*Corporate Cash Alert: 2023 Outlook - Act Now, 1/3/23*).

## Past Tightening Cycles

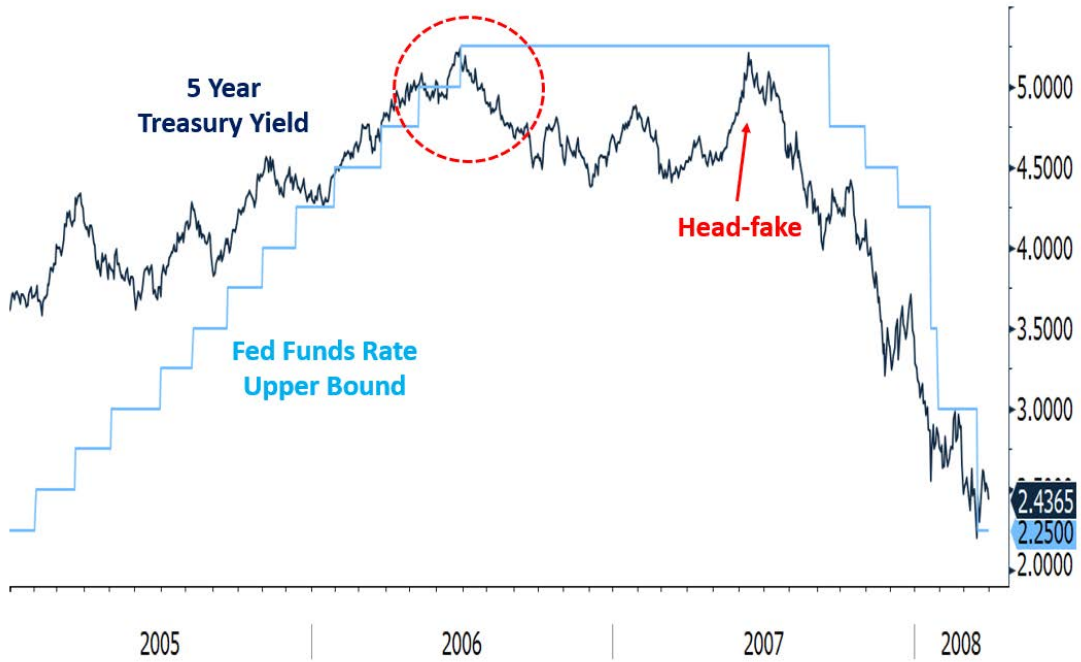
The end stages of the preceding three tightening cycles illustrate precisely this dynamic. Notice how (in all cases), as rates were rising, the market rates were above the Fed Funds rate and moved in lockstep to stay comfortably higher than the policy rate. Then, at a certain point in each cycle, the upward momentum in 2-5-year yields stalled and eventually outright *declined*, ultimately settling at levels below the then-current Fed Funds rate. Although 'head-fakes' sometimes happened, once this critical crossover moment occurred (where market rates were less than the policy rate), it would ultimately prove to presage lower short-term rates and subsequent cuts in Fed Funds.

### 2016-2018 Fed Tightening Cycle



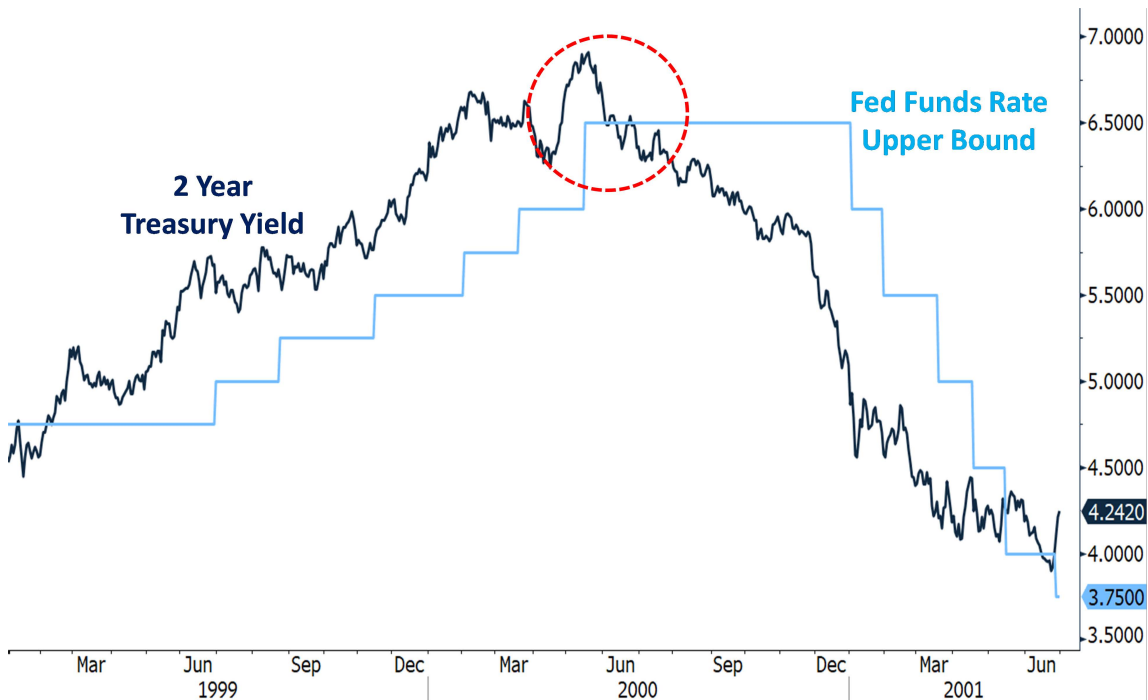
Source: Bloomberg (as of 1/1/2016 - 3/31/2020)

## 2004-2007 Fed Tightening Cycle



Source: Bloomberg (as of 1/1/2005 - 3/31/2008)

## 1999-2000 Fed Tightening Cycle



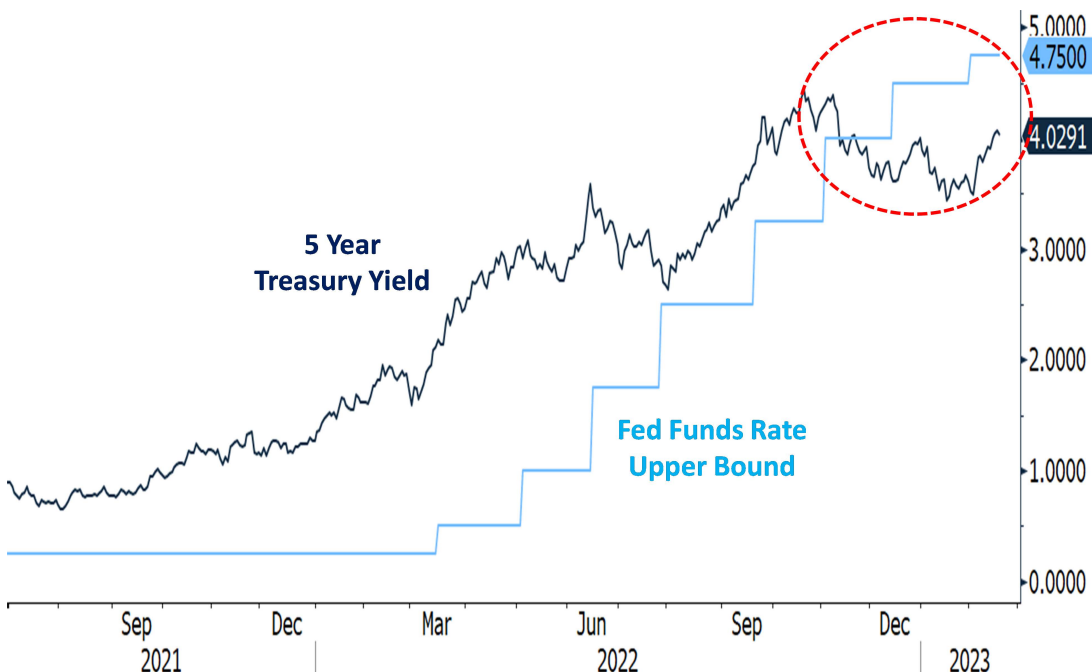
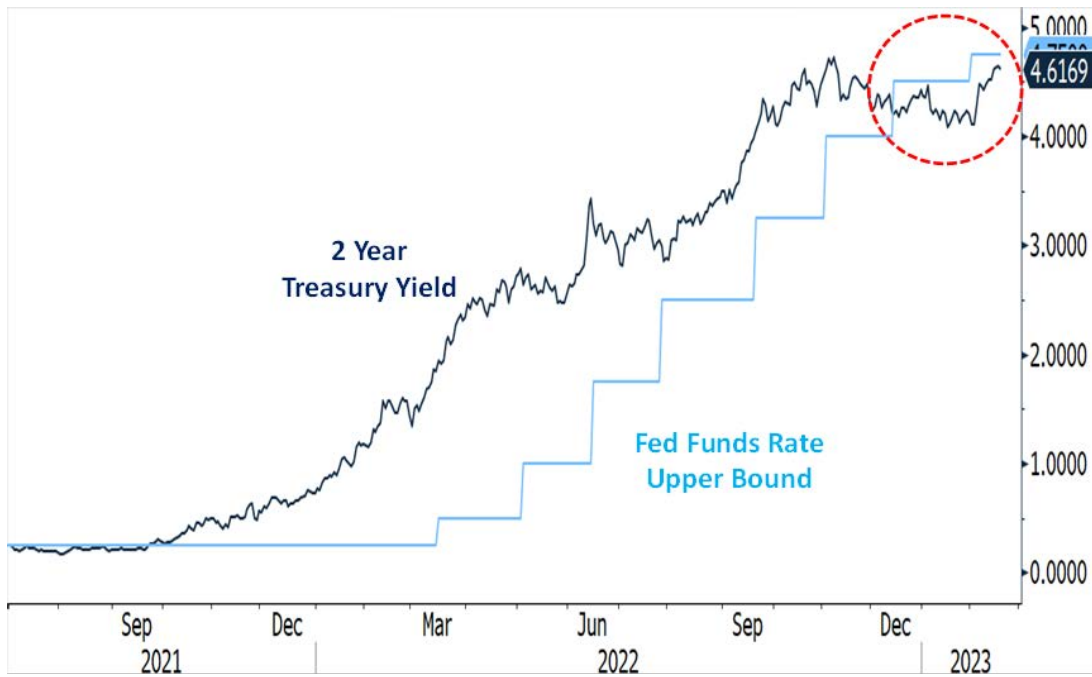
Source: Bloomberg (as of 1/1/1999 - 6/30/2001)

# Skate to Where the Puck's Going

Armed with the knowledge of these historical patterns, consider where we stand today:

- After a rapid sequence of jumbo rate hikes throughout 2022, yields across the curve are materially higher than they have been in many years.
- As we got closer to the widely-expected cyclical peak, longer-dated Treasury yields stopped increasing in lockstep with the Fed Funds increases.
- Recently, those yields crossed below the Fed Funds rate.

### Current Fed Tightening Cycle



Source: Bloomberg (as of 6/30/2021 - 2/17/2023)

## Timeline Before Fed Cuts

As you can see, market action in 2022 is similar to prior periods and now operating on the assumption that we're near the end of this hiking cycle, and the next substantive move will be lower. However, this doesn't mean there won't be a long period of digestion between the last rate hike and the first rate cut. Looking at the previous 3 tightening campaigns, the Fed maintained its peak policy rate for an average of nearly 10 months (288 days).

Timeline of Previous Fed Tightening Cycles

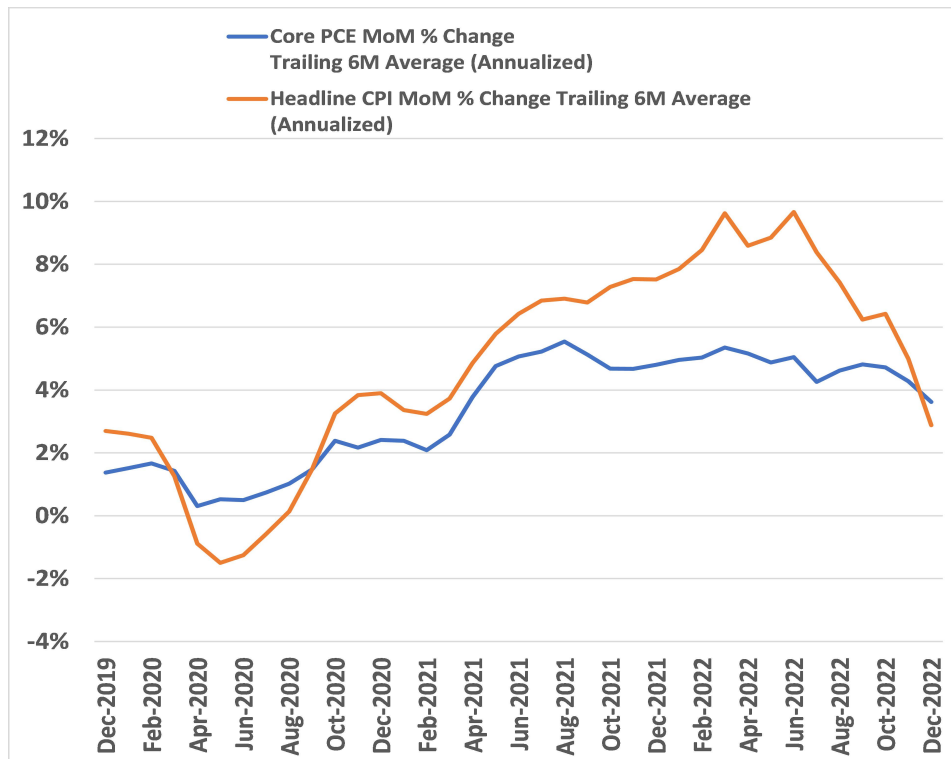
Last Hike of Cycle	First Cut of Cycle	Days Elapsed	Months Elapsed
12/20/2018	6/30/2019	192	6.4
6/29/2006	9/14/2007	442	14.7
5/16/2000	1/2/2001	231	7.7
<b>Average</b>		<b>288</b>	<b>9.6</b>

Source: Treasury Partners calculations

## Inflation Update

Headline inflation - the original impetus for the rapid tightening - remains high, but notably has decelerated from its peak levels. If one digs into the data to average month-on-month figures over the last six months, both headline CPI and core PCE have now ticked below 4% to retrace much of the post-pandemic spike.

Key Inflation Data Trends



Source: Bloomberg/Treasury Partners



## Treasury Partners View

Contingent on economic developments, we expect the Fed to raise the Fed Funds rate to the 5.25-5.50% range (the equivalent of another 2-3 hikes from its current 4.75%). Naturally, additional upside surprises in the data could force the Fed to tighten further, but significant upward risk above 5.50% is a lower probability event. Conversely, our experience is that after the lag effects of the rapid tightening begin taking noticeable effect, rates turn lower (often in a hurry).

Our positioning recommendations vary according to client circumstances and portfolio constraints:

*"In our experience of investing through forty years of market cycles, one of the most consistent patterns is that all parabolic moves (in this case, higher) eventually tend to get walked back (in this case, move lower). Stated differently, rates might tick higher - but once the bond market gets a whiff of a slowdown, rates will likely decline significantly, irrespective of Fed policy. It pays to take advantage of these absolute levels while they're still available."*

**(Corporate Cash Alert: 2023 Outlook - Act Now, 1/3/23)**

- **Cash Burns and Short Final Maturity Limits:** Based on our outlook, we believe all corporate cash clients can benefit from maintaining 3–6-month maturities as the Fed continues to tighten. Investors focusing on this portion of the yield curve will be squeezing the last drops of toothpaste out of the tube over the next few months.

This maturity range is attractive relative to money market funds and preserves flexibility to take advantage of higher 6–12-month rates that will likely be available after expected additional Fed hikes through June 2023. This strategy is particularly suited for mandates with 1-year maximum final maturity constraints and clients with cash burns who won't have the ability to reinvest.

- **Longer Final Maturity Limits:** Clients with longer maximum final maturity constraints are advised to deploy funds out longer-term. For these portfolios, we urge readers to carefully consider what the preceding charts tell us; while levels may move slightly higher in the next few months, the next significant move in yields (likely in 2024) will be lower. Rather than holding out for another 25 or 50 bps of potential upside over a short 3–6-month window of opportunity, extend maturities now and lock in elevated rates for 3-5 years.



- **Positive Cash Flow:** Companies boasting positive cash flow must remember that growing liquidity lowers portfolio duration and heightens exposure to the negative implications of a declining rate environment. In effect, positive cash flow *benefits* during a rising rate environment (by allowing for sequential reinvestments at continually higher rates) but *suffers* in a declining rate environment (since principal payments are reinvested at lower book yields). Front-run this dynamic - extend maturities now.
- **Don't Forget Roll-Down:** Additionally, depending on the slope of the yield curve, investors could benefit from 'roll-down' protection on their longer-dated positions. For example: one year from now, investors who bought today's 4.40% 3- year Treasury will instead be holding a 2-year maturity with a 4.40% purchase yield. Although there's no guarantee this seasoned 4.40% 2-year bond won't be below then-current market rates, the automatic math behind 'rolling down the curve' typically offers some natural protection in an upward sloping yield curve.

**Bottom Line:** The overarching risk-reward tradeoff remains favorable. Rates can potentially rise somewhat higher from this point; but with the appealing absolute rates and the potential for rolldown protection, extending maturities is a viable strategy for those willing to forego some potential upside in exchange for certainty.

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- 19 consecutive years, achieved top 10 rankings on Barron's annual surveys of both "America's Top 100 Financial Advisors" and "America's Top 100 Independent Advisors", and
- An inductee to Barron's "Advisors Hall of Fame".

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**Richard Saperstein**  
Chief Investment Officer  
Email: [rsaperstein@treasurypartners.com](mailto:rsaperstein@treasurypartners.com)  
Phone: (917) 286-2777



**Daniel Beniak**  
Director  
Email: [dbeniak@treasurypartners.com](mailto:dbeniak@treasurypartners.com)  
Phone: (917) 286-2783

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